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Signs Of Economic Recovery Spreading

Recent government reports from Tokyo have concluded that the economy has touched bottom and is on the road to recovery. The Economic Planning Agency said that the recovery began in the first quarter of 1987, as the benefits of the strong yen began to outweigh the impact of falling export volume. The Bank of Japan expects the government's Y6 trillion ($40 billion at Y150=$1.00) stimulus package to accelerate growth in domestic demand to a real annual rate of more than 5 percent during the remainder of fiscal 1987.

The central bank cited healthy growth in housing and capital investment as positive signs. Spurred by record low interest rates, housing starts rose to 1.37 million in 1986, the highest in seven years. The additional funds allocated for the Housing Loan Corp. in the stimulus package will help continue double-digit growth (see Table). The outlook for capital investment is boosted by the expected rise in corporate profits. Nomura Research Institute, for example, predicts a 13.6 percent rise in pretax earnings in FY 1987, the first such increase in three years. In addition, the public works spending contained in the stimulus package will boost public investment.

Industrial Output, Export Volume and Housing Starts

(percentage change from the same period, previous year)

	Mining and Manufacturing Production	Export Volume	Housing Starts
1984	11.1%	15.4%	4.4%
1985	4.6	4.7	4.1
1986	-0.4	-1.4	10.4
1986:I	1.2	-0.2	5.1
1986:II	-0.8	-0.9	3.0
1986:III	-1.1	-0.3	18.5
1986:IV	-0.7	-4.2	15.5
1987:I	0.7	-0.1	12.5
1987:II(p)	0.8	-3.9	23.6

Source: Bank of Japan, Ministry of International Trade and Industry and Japan Tariff Association

A large rise in retail sales in the April-May period indicates that personal consumption, which expanded at a real 7.3 percent annual rate in the January-March quarter, remains strong. Although the 3.6 percent rise won in the 1987 spring wage negotiations was the lowest on record, flat consumer prices in FY 1986 made it the largest inflation-adjusted increase since 1975. Consumers should be further encouraged by the planned reduction in income taxes. On August 7 the Liberal Democratic Party agreed to increase the cut to Y1.5 trillion ($10 billion) as part of an agreement to end a Diet boycott by the opposition parties and allow debate on tax reform to resume on August 18 following a 10-day recess. The parties also agreed to cut national and local income taxes by another Y2 trillion ($13.3 billion) in FY 1988. In addition, the LDP proposed delaying the controversial reform of the maruyu tax-exempt savings system until April 1988 (see JEI Report No. 30B, August 7, 1987).

There are also signs of a turnaround in the manufacturing sector, which fell in tandem with export volume in 1986. Industrial production in the January-March period rose 0.7 percent above the year-earlier level, the first such increase in four quarters. This sector has been strengthened by brisk demand for automobiles in Japan. Domestic sales are running at an annual rate of 4.2 million, close to the 4.3 million record high in 1979, and partially offsetting a drop in exports to the United States. The manufacturing sector is credited with a modest improvement in the employment situation as well. Average overtime hours in June increased from the year-earlier level for the first time in 16 months, while the unemployment rate fell from May's record high 3.2 percent to 3 percent.

Although the overall picture is improving, there continues to be considerable disparity between industries and regions. The unemployment rate is 4.5

percent in the northern island of Hokkaido and 4.1 percent in Kyushu. A recent Keidanren poll reported that 62.8 percent of Japanese business managers do not believe the economy is on the track toward recovery.

Randall S. Jones

Defense Spending Remains On Track

Although Japan's projected 6.2 percent hike in defense spending for FY 1988 is lower than other recent increases -- defense agency officials had sought 6.7 percent -- it should be sufficient to keep the current five-year procurement program on track. In monetary terms the rise translates to Y218 billion ($1.5 billion at Y150=$1.00), bringing total spending to Y3,735.4 billion ($24.9 billion). Depending on Japan's economic performance, the increase will keep total spending above 1 percent of gross national product (spending recently crested the level) but it will not set in motion a stampede toward higher spending. The proposed defense budget benefited from lower costs for fuel as a result of the appreciated yen and higher-than-expected revenues during the past fiscal year (see JEI Report No. 30B, August 7, 1987). Additionally, the five-year procurement program's new status as an official government program -- as opposed to a planning document -- gives it leverage against other budget items.

While the defense budget maintains trends established earlier to strengthen the sustainability of the naval and air self-defense forces, the increase could come under criticism in the United States if it is seen as a means to fund the controversial FSX fighter-support aircraft program rather than to enhance Japan's overall defense position. The FSX decision, which has been delayed any number of times over the past two years, is due once again -- perhaps in September. Domestic lobbying has been intense; industry views the FSX program as a virtual last chance to strengthen its technological and production base in this aspect of the aerospace business.

Emotions are just as strong in U.S. circles, which generally favor acquisition of a U.S. system over a Japanese-developed product for reasons of cost and interoperability. Trade considerations are also a factor, especially in light of the yen's enhanced buying power. While cost estimates for the FSX vary widely, most American analysts say that acquiring a U.S. plane would be far less expensive than developing a domestic version.

The other component of Japan's comprehensive security program -- official development assistance -- received a preliminary increase of 8.6 percent, rising from Y658.1 billion ($4.4 billion) in FY 1987 to Y714.7 billion ($4.8 billion). Both aid and defense spending have received preferential budget treatment in the last several years, but the FY 1988 guidelines slate a much higher percentage hike for ODA than for defense. A quiet but significant debate in Tokyo and Washington concerns Japan's appropriate contributions to global security, particularly since the decision to abolish the cap on defense spending. While there is widespread agreement on the need for additional Japanese inputs, the most effective and politically palatable mix of defense and aid spending remains an issue. The relatively larger increase for aid suggests an emphasis on this less controversial approach.

The decision might also reflect the outlook of Finance Minister Kiichi Miyazawa, who has long supported aid programs but has been one of the most articulate opponents of higher defense spending among Japan's leading political figures. The defense program's official status insulates it from major spending reductions or even a spending freeeze, but with the government's leading defense spending proponent -- Prime Minister Yasuhiro Nakasone -- in his last days in office, that component of the budget may be more vulnerable in budget horse trading during the current drafting process than in recent years.

In contrast, aid programs have a far higher degree of public support and at least two of the three "new leaders" in Japan -- Mr. Miyazawa and former Foreign Minister Shintaro Abe -- are closely identified with aid spending. Finally, after the controversies associated with defense policies over the last two years -- including Japan's participation in the research phase of the Strategic Defense Initiative and the abolition of the 1 percent spending limit -- budget makers may have sought a breather in negotiations over next year's budget by seeking an increase that satisfies policy needs but does not revive opposition party or foreign criticism of defense programs.

Michael W. Chinworth

Banks Report Mixed Profits

Earnings figures show that financial liberalization has increased the already heated competitive atmosphere of Japan's banking market. While most Japanese banks experienced significant gains in profits during FY 1986, foreign banks watched their earnings decline.

According to a survey by an American accounting firm, foreign banks recorded mixed results in the year ended March 31, 1987 (see Table 1). The group surveyed grew by two to 79 firms, helping to push up total assets to just under Y16.6 trillion ($110.7 billion at Y150=$1.00), a gain of 7.1 percent. Recurring revenues dropped by 10.4 percent to Y946.2 billion ($6.3 billion), however, while pretax profits plunged 38.5 percent to Y18.7 billion ($124.7 million). Nevertheless, net profits edged up 0.8 percent to Y12.9 billion ($86 million).

Table 1: Top Foreign Banks in Japan, FY 1986

(ranked by pretax profits in millions of yen)

Rank	Company	Pretax Profits
1	Chemical Bank	Y2,111
2	Bankers Trust Co.	2,032
3	Citibank N.A.	1,635
4	Morgan Guaranty Trust Co.	1,546
5	Korea First Bank	1,518
6	Manufacturers Hanover Trust Co.	1,492
7	Irving Trust Co.	1,383
8	First National Bank of Chicago	1,328
9	Banque Paribas	1,100
10	First Interstate Bank of California	985

Japanese competitors, in contrast, recorded strong profit gains almost across the board (see Table 2). Top-ranked Fuji Bank, Ltd.'s pretax profits jumped almost 42 percent, while second-ranked Dai-Ichi Kangyo Bank, Ltd. (first in terms of total assets) reaped 46 percent more in pretax earnings. Pretax earnings growth rates at the low end of the rankings were even more spectacular, falling in the range of 100 percent.

Table 2: Top Domestic Banks in Japan, FY 1986

(ranked by pretax profits in millions of yen)

Rank	Company	Pretax Profits
1	Fuji Bank, Ltd.	Y218,899
2	Dai-Ichi Kangyo Bank, Ltd.	205,914
3	Mitsubishi Bank, Ltd.	194,086
4	Sumitomo Bank, Ltd.	181,132
5	Sanwa Bank, Ltd.	180,185
6	Mitsubishi Trust & Banking Corp.	155,944
7	Industrial Bank of Japan, Ltd.	150,981
8	Sumitomo Trust & Banking Co., Ltd.	145,710
9	Mitsui Bank, Ltd.	144,782
10	Mitsui Trust & Banking Co., Ltd.	107,447

Note: Unconsolidated results

Source: Japan Economic Journal

The entry of domestic banks into areas previously reserved for foreign banks was a major factor in the results. Domestic institutions grabbed market share in foreign exchange operations, foreign currency-denominated loans and overseas transactions (particularly in the European markets). Given their superior client base, it is not surprising that these firms quickly displaced foreign banks as the major players in these markets.

In fiscal 1985 these areas were major money-earners for foreign firms because of volatile exchange markets and a frenzy of foreign bond buying. Unlike their domestic counterparts, foreign banks actively and aggressively traded foreign currencies and futures for Japanese clients, earning handsome fees. Most analysts agree that as exchange rates grew more stable in the latter part of FY 1986, the profit potential in the exchange market declined. Similarly, the growth of Japanese bond purchases started to level off, putting another dent in earnings.

To counter these developments, foreign banks are retreating to niche markets, using mutual funds, specialized foreign currency dealing and futures of various kinds in their counterattack. One promising area is the management of trusts denominated in foreign currencies and tokkin funds (specified accounts) aimed at overseas markets. Japanese regional and sogo (mutual savings and loan) banks, as well as medium-sized companies, had entrusted an estimated $1 billion worth of these funds to foreign institutions as of February.

Increased interest in foreign stocks and real estate is one motivation behind this development.

Whether these strategies will help remains to be seen. Given the fact that Japanese banks now dominate global bank rankings (in terms of assets), foreign banks face competitors with extremely deep pockets. It is clear, however, that financial liberalization is having a significant impact on the competitive atmosphere of the Japanese market. All financial institutions, foreign and domestic, must adapt in order to survive.

Jon Choy

Bearing Makers File National Security Trade Complaint

U.S. manufacturers of bearings are in trouble. Virtually everyone agrees on this point. Why is another matter. Industry executives place the blame squarely on their foreign rivals, arguing that expanding imports over the last 20 years, particularly from Japan, have eroded the competitive position of American makers. An equally controversial question is whether the bearings industry requires government help. U.S. corporate officials have no reservations on this score. Maintaining that only an import rollback will insure adequate domestic supplies of a component vital to the functioning of weapons systems as well as military and commercial transportation equipment and most types of industrial machinery, the Anti-Friction Bearing Manufacturers Association has appealed to the Reagan administration for across-the-board protection from foreign competition on national security grounds. In a petition filed July 17 under Section 232 of the 1962 Trade Expansion Act, the trade association asked the government for import quotas ranging from zero for high precision grades of bearings used in military applications to roughly 34 percent of apparent domestic consumption on a volume basis for commodity products.

American producers of both ball bearings (used when speed is the key requirement) and roller bearings (for applications where load-bearing capacity is more important) have unquestionably fallen on hard times. For starters, domestic demand for bearings has increased slowly during the current economic expansion because of less-than-peak conditions in a handful of major end-users markets. Output in the automotive industry -- the single-largest customer, accounting for nearly one-fourth of consumption -- is still below the levels of the late 1970s. The same is true in the farm machinery, construction equipment, machine tool and oilfield/mining equipment industries. Demand has strengthened in the aerospace industry and a few other important capital goods markets, but growth in these sectors has barely offset reduced orders from elsewhere.

In the industry's version of its problems, the demand side of the picture takes a definite backseat to the increased inroads foreign suppliers have made in the U.S. market. Imports of ball and roller bearings and parts totaled $662.9 million last year, with 44 percent of this amount coming from Japan. But because offshore producers have concentrated on low-value, high-volume products, domestic makers argue that imports' estimated 17 percent market share in dollar terms seriously understated the problems caused by foreign competition. The true measure, they say, was 1986's 64.5 percent import penetration